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In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 247

RAILWAY EXPRESS AGENCY, INCORPORATED,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 4-39) are reported at 8 T. C. 991. The opinion of the Court of Appeals (R. 65-75) is not yet officially reported.

JURISDICTION

The judgment of the Court of Appeals (R. 75-76) was entered July 19, 1948. The petition for a writ of certiorari was filed on August 27, 1948. The jurisdiction of this Court is invoked under 28 U.S.C., Sec. 1254.

QUESTIONS PRESENTED

1. The taxpayer is a regularly organized corporation, owning valuable assets and employing officers and employees, and engaging in express transportation in its own name. Its operations are conducted under identical contracts with over 400 railroads. Under these contracts the taxpayer collects its revenues from the public and after deducting its expenses and other items it distributes the balance as "Rail Transportation Revenue" to the contracting railroads as compensation for their transportation of express shipments for the taxpayer. All but a fraction of "Rail Transportation Revenue" is distributed to the 70 Class 1 railroads which own all of the taxpayer's stock. The principal question presented is whether the Court of Appeals was correct in holding that the taxpayer was taxable on that portion of its receipts less expenses which was not distributed to the railroads.

2. In the event the first question is answered in the affirmative, the further question is whether the Court of Appeals was correct in holding that the taxpayer was not entitled to a credit under Section 26 (c) (1) of the Revenue Act of 1936 in computing the surtax on undistributed profits for the year 1937.

STATUTES AND REGULATIONS INVOLVED

The applicable provisions of the statutes and regulations involved are set forth in the Appendix, *infra*, pp. 16-19.

STATEMENT

Although the Tax Court's findings of fact are extensive (R. 5-22) the pertinent facts may be summarized as follows:

Prior to 1929, a nation-wide express service had been performed under uniform contracts with the railroads by the American Railway Express Company, an independent company. In anticipation of the termination of contractual relations with American, a committee representing the railroads prepared a detailed plan for the carrying on of the express business after February 28, 1929. (R. 6.) The plan as ultimately adopted provided for the organization of a new express company by the 86 railroads which handled approximately 98 per cent of the gross express business on all railroads. (R. 7-8.) Accordingly, the taxpayer was incorporated in Delaware on December 7, 1928. Its corporate powers are quite broad, covering activities much more extensive than the express business. (R. 10-11.) It had an authorized capital stock of 1,000 shares without par value which was issued to the 86 railroads on the basis of the express business done by them in the past. (R. 7.) Subsequently, by reason of various mergers and consolidations of some of its stockholders, the number of stockholders was reduced to 70 railroad companies by the end of 1938. (R. 11.)

In order to obtain funds for the purchase of the property of American, the taxpayer issued $32,000,000 of five per cent bonds under a trust inden-

ture. These bonds were sold to underwriters who sold them to the public. The rights of the taxpayer under its contracts with the railroads were pledged in the trust indenture as security for the payment of the bonds and interest thereon, as to which the taxpayer was solely liable. The indenture further provided that the taxpayer would not mortgage or pledge its rights under the contracts with the railroads except in subordination to the lien of the indenture. The indenture made all indebtedness of the taxpayer subordinate to the bonds to be issued thereunder. It contained an agreement on the part of the taxpayer not to modify the agreements with the railroads without the written consent of the trustee, as well as a provision, in case of default by the obligor, for operation or sale of the property for the benefit of the bondholders. (R. 17-18.)

The taxpayer has operated its express business under separate identical contracts, called "Express Operations Agreements", with substantially all of the railroad companies in the United States. During the tax years in controversy, over 400 railroads, including those which were stockholders, were parties with the taxpayer to such Express Operations Agreements. These agreements, which expire February 28, 1954, designated the taxpayer as the exclusive agent of the railroads for the conduct of the express transportation business and for the collection, disbursement and division of revenue accruing under the agreements. The taxpayer was,

however, authorized to file tariffs and other rules and regulations with the Interstate Commerce Commission on its own behalf and on behalf of the railroads. (R. 11-12.) Moreover, as between the taxpayer and the railroads, the former was liable for loss to its own property and for injury to its own employees and agents. (R. 17.) Nothing in the agreements limited the right of the taxpayer to appoint and exercise control over its employees. Provision was made for the arbitration of disputes on request, resort to such arbitration being a condition precedent to any further action. (R. 16.)

The terms of the agreements fixed the amounts payable by the taxpayer to the contracting railroads as, in short, gross revenue less expenses. The agreements contemplated that all of the taxpayer's income and expenses, as defined therein, including depreciation, should be taken into account in arriving at the amount distributable to the railroads, each of which was to receive a share proportionate to the amount of express business it had handled on its line. The amount distributable to the railroads was termed "Rail Transportation Revenue". The deductions allowed the taxpayer in computing "Rail Transportation Revenue" were particularized. Thus the taxpayer was authorized to deduct from the moneys received by it certain items that were designated as net income items, including appropriations from "net income" for investment in physical property. Also certain "surplus" items could be deducted, including "sur-

plus set aside for investment in physical property." (R. 12-15.)

During 1937 and 1938 in determining "Rail Transportation Revenue", the taxpayer deducted from its income those charges and items of expense which were provided for in its agreements with the railroads. Included therein were deductions for depreciation aggregating some $2,000,000 for each year, computed in the manner as ordered by the Interstate Commerce Commission. The balance it distributed among the railroads with which it had agreements. These depreciation allowances were claimed as deductions in its returns for 1937 and 1938. The Commissioner ruled that these deductions for depreciation were excessive in amounts aggregating over $600,000 and accordingly he determined the deficiences involved herein. There is no dispute as to the propriety of the Commissioner's action in reducing the depreciation deductions. (R. 19-20.)

The taxpayer's returns for 1937 and 1938 showed income and excess profits taxes due in amounts aggregating some $25,000. The taxpayer has paid these taxes. (R. 21.) In 1945 the taxpayer obtained from the Interstate Commerce Commission permission, retroactive to January 1, 1937, to account for depreciation charges on the basis found by the Commissioner. However, the taxpayer has as yet taken no action upon this permission in view of the pendency of these proceedings. (R. 20.)

The Tax Court sustained the Commissioner's determination of deficiencies based on excessive depreciation deductions, but reduced the 1937 income tax deficiency on the ground that the taxpayer is entitled to a credit under Section 26 (c)(1) of the Revenue Act of 1936 (Appendix, *infra*) in computing the surtax on undistributed profits for the year 1937. (R. 22-39.) The Court of Appeals affirmed the Tax Court's holding that the taxpayer is taxable on the excessive depreciation it claimed as well as on the net income it reported in its returns. However, the Court of Appeals, one judge dissenting, reversed the Tax Court on the credit issue. (R. 66-75.)

ARGUMENT

1. Both the Tax Court and the court below held that the amounts determined by the Commissioner as excessive depreciation must be treated as income taxable to the taxpayer. The taxpayer contends that under the Express Operations Agreement it is only the agent of the railroads and that, therefore, all of its income from express operations is taxable only to the railroads which are parties to the agreement. The facts as to the manner in which the taxpayer has conducted its business and determines the Rail Transportation Revenue payable to the railroads clearly support the decision below.

The taxpayer is a regularly organized corporation carrying on a type of business which is engaged in for profit by many corporations such as trucking companies. In fact, the taxpayer's ex-

tensive business was for many years conducted by the American Railway Express Company for its own account and for profit. The taxpayer has broad corporate powers and holds title in its own name to millions of dollars worth of real and personal property which it uses in its business. The acquisition of the taxpayer's properties from American was financed almost entirely from the proceeds of the taxpayer's interest-bearing bonds which were sold to the public and secured only by the taxpayer's assets and earning power. The taxpayer has complete control over its own employees, and is solely responsible for its obligations. Here is no corporate shell or a mere department of a larger integrated business, but rather a genuine enterprise with its separate assets, revenues, employees and accounts.

The taxpayer paid over to the railroads for each of the years 1937 and 1938 in excess of $50,000,000 in "Rail Transportation Revenue", the taxability of which is not in issue. What is important here is that under its contracts with the railroads, the taxpayer was given considerable latitude in computing "Rail Transportation Revenue". For example, it was authorized to deduct amounts representing "surplus set aside for investment in physical property." Of particular relevance, the taxpayer's authority to make deductions for depreciation was not limited to the amounts allowable for tax purposes. Thus, as the court below pointed out, the taxpayer's contracts with the railroads enabled it

at its option "to increase its physical properties out of funds which would otherwise be distributable to the contracting railroads" (R. 71).

In the light of these facts, the Tax Court and the court below were clearly correct in finding that no principal-agent relationship existed between the taxpayer and the railroads. Furthermore, under common law agency concepts, the agent must possess power to alter legal relationships between the principal and third persons. *Restatement of the Law of Agency*, section 12. The taxpayer here, by agreeing to use its own property and organization in carrying on its own business with the public, was not granted any authority to create and alter legal relationships between the railroads and anyone else. Consequently, no principal-agency relationship was created.

The decision below was required by established legal principles. The economic earner of income cannot render himself immune from taxation by agreeing that another shall be the "owner" of the income which is produced by the former's property and services, and by denominating the parties "principal" and "agent". Facts, rather than labels, determine tax liability. *Griffiths* v. *Commissioner*, 308 U. S. 355; *Higgins* v. *Smith*, 308 U. S. 473; *United States* v. *Joliet & Chicago R. Co.*, 315 U. S. 44. Where, as here, there is no true principal-agent relationship, calling a corporation the agent of its several stockholders is only another manner of contending that the corporate entity

should be disregarded. *Moline Properties* v. *Commissioner*, 319 U. S. 436, 440-441.

The taxpayer seeks (Pet. 16) to distinguish the present case from *Moline Properties* v. *Commissioner*, *supra*, and similar cases in which this Court has refused to disregard for tax purposes the corporate entity of a wholly owned subsidiary. It argues that since its "nominal stock" is held by only 70 of the more than 400 contracting railroads, the Express Operations Agreement was "an arms' length arrangement" and that hence the earnings of the express business are not distributed as dividends. Suffice it to say that *Moline Properties* v. *Commissioner* did not turn on the narrow question whether the distribution of the wholly owned subsidiary's income to the parent was tantamount to the payment of dividends. Too, from a factual standpoint, the taxpayer's argument loses force when it is recalled that the 70 stockholding railroads are Class 1 railroads which receive all but a small fraction of the "Rail Transportation Revenue" which is distributed by the taxpayer to the contracting railroads.[1]

That the taxpayer did in fact retain as surplus at least the amounts of excessive depreciation, totalling nearly two-thirds of a million dollars, cannot be contradicted. In the hands of taxpayers generally

[1] In 1928, the year the taxpayer was incorporated, the stockholding railroads performed about 98 per cent of the gross business transacted under the contracts with taxpayer's predecessor. (R. 7-8). There is no indication in the record that this percentage has decreased since 1928.

such amounts are obviously taxable income. Although the taxpayer obtained from the Interstate Commerce Commission, some seven years after the close of the taxable period here involved, *permission* to account for depreciation charges by including in its accounts amounts found by the Commissioner to be allowable, no such adjustments have in fact been made in "Rail Transportation Revenue." And even if these adjustments are made at some future time, they would be the result of a voluntary action on the part of the taxpayer. The relinquishment of income under such circumstances does not alter the incidence of taxation. *Corliss* v. *Bowers*, 281 U. S. 376, 378.

2. There is no conflict in decisions. The taxpayer (Pet. 11-12) urges that *Bowles* v. *Railway Express Agency*, 65 F. Supp. 852 (N.D. Ill.), affirmed *sub nom. Fleming* v. *Railway Express Agency*, 161 F. 2d 659 (C.C.A. 7th), is irreconcilable with the conclusion of the court below. However, the Tax Court carefully considered that contention and rejected it on the ground, among others, that the court in *Bowles* v. *Railway Express Agency* expressly pointed out that its decision did not relate to tax liability. (R. 30.) It is quite understandable, therefore, that the Court of Appeals took no further notice of the contention.

The views of the Tax Court with respect to *Bowles* v. *Railway Express Agency* apply in large measure to the Arbitrators' Decision of July 15,

1948, which the taxpayer (Pet. 13-14) says is directly contrary to the decision below. The Arbitrators' Decision related primarily to accounting methods employed by the taxpayer in computing the distributable shares of "Rail Transportation Revenue", and specifically to an agreement (the Economy Plan) supplementary to the Express Operations Agreement. The taxpayer's right to make deductions of amounts to be retained by it was not there involved. That the Economy Plan has no bearing on this tax controversy is adequately demonstrated by the taxpayer's failure to refer to it heretofore in this litigation. Moreover, the Decision makes no reference whatever to this taxpayer's liability under the taxing statute.

The taxpayer (Pet. 13) also seeks to establish a conflict between the decision below and rulings made by the Interstate Commerce Commission. But as the Tax Court pointed out (R. 31-32), the taxpayer is "required to account for its gross income pursuant to provisions of the applicable revenue act, and in doing so, disregard, if necessary, accounting rules prescribed by the Interstate Commerce Commission", citing *Old Colony R. Co.* v. *Commissioner,* 284 U. S. 552.

Stating (Pet. 16) that this Court "has never refused to give legal effect to a bona fide contractual relationship under such circumstances", the taxpayer makes a broad claim to a conflict with other decisions of this Court, without citing them. This Court has repeatedly looked at the substance rather

than the form of agreements in taxing income to him who earns it.

3. The decision below need not be disturbed, irrespective of this Court's disposition of *National Carbide Corp.* v. *Commissioner,* No. 151, and related cases. As the Court of Appeals stated (R. 70), "this case seems yet more clearly against this taxpayer than did that [National Carbide]", pointing out many elements of the relationship between the taxpayer and the railroads not present in that case. In *National Carbide* the wholly-owned subsidiary admittedly was taxable on the nominal amount it *retained* as compensation; the controversy there related to the amounts *paid over* to the parent. For present purposes, it is unnecessary to draw a parallel between the "Rail Transportation Revenue" the taxpayer here distributed to the railroads and the amounts paid over to the parent by National Carbide; the taxability of the amounts *retained* by the taxpayers in both cases cannot be seriously questioned. Thus it is clear that while the decision below is consistent with and supported by *National Carbide,* this case can stand alone.

4. There is no occasion for this Court to review the decision of the court below with respect to the undistributed profits surtax credit provided by Section 26 (c) (1) of the Revenue Act of 1936 for earnings which cannot be distributed as dividends without violating a written contract. The taxpayer's Express Operations Agreement with the

railroads requires the taxpayer to pay over to the railroads, in proportion to the amounts of express business handled by each, all of its income minus certain specified classes of deductions. The Agreement specifically excludes dividend disbursements from such authorized deductions. The Court of Appeals, with L. Hand, J., dissenting, held that the payment of dividends out of the sums retained by the taxpayer as excessive depreciation deductions would not violate the Agreement. In thus holding that the taxpayer is not entitled to this credit, the Court of Appeals correctly applied the decisions of this Court in *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, and *Helvering* v. *Ohio Leather Co.*, 317 U. S. 102, to the facts in this case.

5. This case is not a matter of such public importance as to require that it be heard by this Court, as the taxpayer contends (Pet. 16-18). The Commissioner is not seeking to tax this taxpayer on the "Rail Transportation Revenue", exceeding $50,000,000 in each of the years 1937 and 1938, which was distributed to the railroads. Only the relatively nominal amounts of income over expenses which the taxpayer *retained* are involved in these proceedings. Were the Commissioner seeking to tax "Rail Transportation Revenue", the taxpayer would then have cause to apprehend that "substantially all the express business of the country" (Pet. 16) would be affected by the outcome of this case.

CONCLUSION

There is no conflict of decisions. The case was correctly decided by the court below in accordance with the controlling decisions of this Court. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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SEPTEMBER, 1948.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

(C) In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount allowed as a credit under section 26 (d).

(D) In the case of a national mortgage association created under Title III of the National Housing Act, the amount allowed as a credit under section 26 (e).

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10

per centum and not in excess of 20 per centum of the adjusted net income.

17 per centum of the portion of the undistributed net income which is in excess of 20 per centum and not in excess of 40 per centum of the adjusted net income.

22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.

27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income.

* * * * *

SEC. 22. GROSS INCOME.

(a). *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts Restricting Payment of Dividends.*—

(1) *Prohibition on payment of dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

* * * * *

Section 22 (a), Revenue Act of 1938 c. 289, 52 Stat. 447, is the same as the corresponding section of the Revenue Act of 1936.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 26-2. *Credit in connection with contracts restricting payment of dividends.*— * * *

* * * * *

(b) *Prohibition on payment of dividends.*—The credit provided in section 26 (c)(1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the

amounts which it can distribute within the taxable year as dividends. If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the provisions of a contract, but can not be distributed within the taxable year as a dividend in another form (as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without violating the provisions of a contract, but can not be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—

then the amount is one which, under section 26 (c) (1), can be distributed within the taxable year as a dividend without violating such provisions.

* * * * *

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